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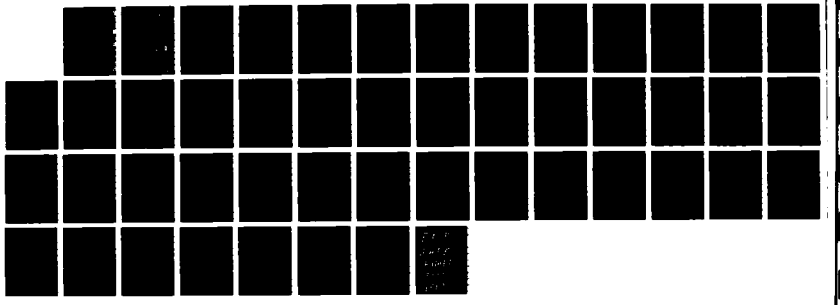

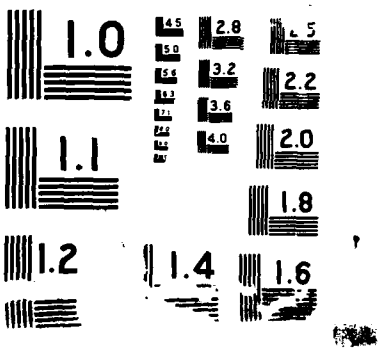
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# IMPROVING DoD RELATIONS WITH INDUSTRY

Report AL713R1

October 1987

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## Executive Summary

## IMPROVING DoD RELATIONS WITH INDUSTRY

DoD's relations with industry have seldom, if ever, been worse. A wide range of issues divide the parties. Defense industry officials believe that costs and risks are being shifted unjustly from DoD to industry and complain that the defense business is being "criminalized." Many in Government, on the other hand, share a sense that industry has been skirting the acquisition regulations, engaging in a game of "catch me if you can." Acquisition managers on both sides believe that unprecedented and unwarranted forays into DoD procurement and program management by DoD's increasingly powerful auditors and inspectors have exacerbated the strains in the relationship.

Tensions between DoD and its contractors are inherent in the political and regulatory environment in which they operate. The political environment is characterized by record-level defense budgets and an attendant spotlight on real and perceived procurement problems. The regulatory environment is distinguished by the unique dual role of DoD, acting as both customer and regulator. Given this environment, strains are to be expected. If they are to be controlled, communication and understanding must be promoted. Yet, DoD has no established mechanism for maintaining a structured dialogue with the defense industry on the important issues of the day.

We recommend establishment of a DoD-Industry Forum under the auspices of the National Academy of Public Administration. The NationalAcademy – the first congressionally chartered organization since the National Academy of Sciences was chartered in 1863 – is charged with improving the effectiveness of Government management. As the sponsor of the Forum, the National Academy would bring senior executives from DoD and industry together to discuss defense acquisition problems and explore solutions.

As we conceive it, the Forum would be chaired by the Under Secretary of Defense for Acquisition. The DoD membership would be comprised of the Assistant Secretary of Defense (Production and Logistics) and the Policy Initiatives Committee

of the Defense Acquisition Board [senior procurement executives from each of the Military Departments plus the Deputy Assistant Secretary of Defense (Procurement)]. Twelve industry CEOs, selected by the Academy with advice from industry associations and DoD, would represent the contractor community.

The Forum would meet quarterly. Meeting agendas would be focused on three or four specific issues. Discussions of company-specific problems would be prohibited. Complex issues of particular importance would be addressed in detail by joint DoD and industry working groups.

The wholesale procurement reforms of recent years have been introduced without adequate industry involvement. DoD cannot unilaterally set the terms and conditions of its business relationship with its suppliers and expect to maintain a spirit of cooperation. The DoD-Industry Forum would provide an effective and efficient means of improving communications and help to build a cooperative buyer-seller relationship. Such a mechanism should be added to DoD's acquisition policy formulation and implementation process.

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# CHAPTER 1

# FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

## INTRODUCTION

> Our study of defense management compels us to conclude that nothing merits greater concern than the increasingly troubled relationship between the defense industry and government – Packard Commission Report, June 1986.[1]

In response to public and congressional perceptions of widespread waste and fraud in defense procurement, DoD has changed its procurement policies and practices significantly. While the legitimate concerns of the parties will inevitably result in occasional conflict, some of the recent changes are perceived by defense contractors as unfair and have intensified an already adversarial relationship.

The Logistics Management Institute (LMI) was tasked to examine the contentious issues in DoD-industry relations and explore the underlying causes of today's adversarial relationship. We were also asked to develop a mechanism for improving DoD relations with industry and to prepare a plan for implementing the proposed mechanism. The balance of this chapter presents a summary of our findings and conclusions and our recommendations for improving DoD-industry relations.

## FINDINGS

There is nothing new about adversarial relations between DoD and industry. Ever since the Revolutionary War, the pendulum has swung back and forth between cooperation and confrontation. Tensions between DoD and its contractors are inherent in the political and regulatory environment in which they operate. Currently, the political environment is characterized by record defense budgets and an attendant spotlight on real and perceived procurement problems. The regulatory

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[1] *A Quest for Excellence*, Final Report to the President by the President's Blue Ribbon Commission on Defense Management, p. 75.

environment is distinguished by the unique dual role of DoD, which acts as both customer and regulator.

In many cases, DoD is the only customer for a company's product or service. Even when it lacks this monopsonistic power, however, it wields tremendous economic influence by virtue of its unrivaled purchasing power. In developing new weapon systems, DoD and its contractors often work closely together, functioning more nearly as partners in a joint venture than as commercial-style customer and supplier.

The Government, as sovereign, is also the rulemaker in its relationship with industry. Its capacity to write procurement statutes, contract clauses, procurement regulations, and management procedures governing its suppliers makes it a fundamentally different kind of customer. In other regulated industries, such as public utilities, the regulator is a neutral third party charged with finding the middle ground between the interests of customers and suppliers. In the defense sector, the customer is the regulator, setting the terms and conditions of the business relationship.

This dual relationship has resulted in cyclical swings between emphasis on the regulator role and emphasis on the customer or partner role. While such swings are common, one observer after another, in industry, Government, and academia, has commented that relations have seldom, if ever, been worse.

Many issues divide the parties. Some of these issues stem from recent DoD initiatives aimed at restoring public and congressional confidence in DoD's procurement process and at maintaining support for the defense modernization program. These initiatives are, in large part, a reaction to public and congressional concerns about fraud and waste raised by defense procurement "horror stories." These concerns and the fiscal realities of large budget deficits have resulted in a variety of "cost-cutting" and "antifraud" measures.

Industry's perception of these changes is that they are intended to make defense procurement more economical for the customer while requiring greater financial risks, smaller profits, and more investment of time, money, and manpower on the part of the suppliers. In addition, industry is concerned with DoD's "overemphasis" on fraud, complaining that complex accounting judgments and regulatory interpretations, formerly matters for negotiation, are now matters for

criminal prosecution. In short, industry is nearly unanimous in its belief that (1) costs and risks are being shifted unjustly from DoD to industry and (2) the defense business is being "criminalized."

The DoD perspective on Government-industry relations is surprisingly similar to industry's in some respects. Many in Government agree that most of the contentious issues being debated today stem from initiatives aimed at restoring public and congressional trust in DoD procurement and the defense modernization program. There is also broad agreement that some recent policy changes are in fact cost-cutting measures necessitated by budget cuts and the current fiscal climate. Even the list of contentious issues cited by Government personnel closely mirrors industry's list.

But there are fundamental differences in the two viewpoints. Much of the defense industry views DoD's recent policy initiatives as long on public relations and short on merit. The consensus in Government, on the other hand, is that, while some changes have in fact been overreactions, most of them have merit. There is a feeling that industry has been skirting the acquisition regulations, engaging in a game of "catch me if you can." Government personnel express frustration at industry practices viewed as extravagant and wasteful and point out the need for everyone involved in the defense effort (Government and industry) to "tighten their belts" and get more value for the defense dollar.

## CONCLUSIONS

The major issues that have emerged can be grouped into four categories – DoD financial regulations, the role of the auditor, fixed-price contracts and cost sharing, and criminalization and fraud – as follows:

*Financial Regulations.* Key issues here include progress payments, profit policy, and the financing of special tooling and test equipment. Various groups are now undertaking studies of the cumulative impacts of changes in the financial regulations governing DoD contractors. If a continuation of the acrimonious debate over these issues is to be avoided, DoD and industry must agree on one set of facts and arrive at a fair and equitable policy based on joint analysis of those facts.

*Role of the Auditor.* Both the industry and Government acquisition communities are concerned about the roles being played by DoD's increasingly powerful auditors and inspectors. Discussions are needed to reach a mutual understanding of what is meant by such terms as "audit," "review," and

"survey" and who performs these functions when, why, and how often. There is evidence that some of the problems of "audit" or surveillance result from misunderstanding and misinformation. Efforts are under way to collect detailed information on the extent of the "duplicative audit" problem. Joint DoD-industry analysis of the data could provide the basis for detailed discussions between DoD and industry leading to an improved understanding of the proper scope of Government oversight.

*Fixed-Price R&D Contracts and Cost Sharing.* The increased use of fixed-price R&D contracts and cost-sharing arrangements has raised concerns about the equitable allocation of risks between DoD and industry. DoD and industry need to reach a common understanding of how fixed-price contracts are being used and when they are appropriate. The impact of DoD's cost-sharing policies also needs to be carefully monitored.

*Fraud, Criminalization, and Self-Governance.* Has DoD changed the rules of the game and "criminalized" the defense industry, or has industry betrayed the public trust and jeopardized the nation's defense modernization program through "fraud, waste, and abuse"? These highly emotional issues are among those currently being debated. The Packard Commission advocated the creation of industry "self-governance" programs to defuse the debate and restore public confidence in the defense industry. Both DoD and industry have accepted the Commission's recommendation, but many problems are surfacing in the implementation of contractor self-governance programs. DoD and industry will have to work closely together and communicate openly if these difficulties are to be overcome and the corporate self-governance approach is to prove successful.

The common denominator underlying these contentious issues is the political and regulatory environment in which DoD and its suppliers operate. When political pressures increase, as they have in recent years, the regulatory system must respond. Because of the unique dual role of DoD, as both customer and regulator, increased regulatory activity unavoidably places a strain on customer-supplier relations.

This political and regulatory environment is a fact of life. Given this environment, effective communication between the parties is essential to minimize the inevitable strains in the relationship. Beyond the specific procurement issues being debated and the broader political and regulatory environment, the single factor primarily responsible for today's adversarial climate is poor communication between industry and DoD. Yet, DoD has no established mechanism for maintaining a structured dialogue with industry on the important defense business

management issues of the day. Such a mechanism should be added to DoD's acquisition policy formulation and implementation process.

The wholesale procurement reforms of recent years have been introduced without adequate industry involvement. The Government cannot unilaterally set the terms and conditions of its business relationship with its suppliers and expect to maintain a spirit of cooperation. Policy decisions with major financial and operational impacts on the defense industry should not be made without thorough analysis. Such analysis is usually not possible without open and detailed discussions with the suppliers that will be affected by policy changes. The Department must establish clear lines of communication with industry in order to build a cooperative arms-length buyer-seller relationship. If the relationship is to be improved, there must be effective industry input in the policy formulation phase and effective industry feedback in the policy implementation phase.

The issues identified in the course of this study beg for understanding and clarification. All lend themselves to improvement by the application of common sense, good will, and exchange of ideas.

## RECOMMENDATIONS

To achieve the improved communication that we have concluded is sorely needed, we recommend establishing a DoD-Industry Forum under the aegis of the National Academy of Public Administration (the National Academy). Its purposes would be to improve the dialogue between DoD and industry, restore mutual trust, and facilitate the establishment of a cooperative, arms-length relationship under the neutral auspices and influence of the National Academy. The Forum would provide a continuous and regular channel for two-way discussion between senior DoD executives and defense industry leaders. Forum members would work together to identify and examine issues in DoD-industry relations and to develop solutions where appropriate.

The Forum would be sponsored by the National Academy, which is chartered by Congress to provide independent advice and counsel on the organization, processes, and programs of Government. It would host quarterly meetings, develop agendas with the advice of DoD and industry, and facilitate the exchange of views on important issues in DoD-industry relations.

The Forum would be chaired by the Under Secretary of Defense for Acquisition. The DoD membership would be comprised of the Assistant Secretary of Defense (Production and Logistics) and the Policy Initiatives Committee of the Defense Acquisition Board [senior procurement executives from each of the Military Departments, plus the Deputy Assistant Secretary of Defense (Procurement)]. Additional DoD executives could be invited when consideration of the issues to be discussed would benefit from their presence.

Industry members would be selected by the National Academy, with consultation and advice from industry associations and DoD. Twelve chief executive officers (CEOs) would serve as core members of the Forum. Supplemental industry attendance would be tailored to the particular issue being discussed. Industry members would be chosen for their ability to provide expert opinions. They would be chosen because of their personal backgrounds in defense industry management and not on the basis of company or other affiliation. Industry members would serve revolving 3-year terms. An industry representative would serve as vice-chairman of the Forum.

The chief benefits of the Forum would be improved communication, better policy analysis, and an opportunity for consensus building. Improved communication would be achieved by means of discussions that are off the record, structured, and efficient. Off-the-record discussions enable the parties to get to the real issues affecting DoD-industry relations while avoiding the headlines and institutional posturing that accompany public forums. Structured discussions – focused on a narrow agenda and well staffed by joint working groups – allow Forum participants to get beyond superficial considerations and gain a deeper understanding of current problems and what can be done about them. Multilateral discussions involving the Military Departments, OSD, and 12–15 industry spokespersons are more efficient than the separate bilateral discussions characteristic of recent years. Finally, multilateral discussions may help to encourage more uniformity among the Military Departments and OSD.

Sound policy analysis requires industry input in the formulation stage and industry feedback in the implementation stage of the policy process. The DoD-Industry Forum and its joint working groups are designed to improve policy analysis by providing these inputs. We recognize that many contentious issues are "zero sum" issues where no "solution" will be acceptable to all concerned. But we believe

that, at a minimum, the Forum will give industry the feeling that its views have been heard before a policy is set.

On those issues that are not "zero sum," the Forum and the National Academy can help industry and DoD to find some common ground through in-depth discussions and the use of common data and joint analysis. As a result, a consensus can be reached and recommendations can be developed to resolve many of the issues straining DoD-industry relations. The result, we believe, will be a renewed spirit of cooperation and a more efficient, effective DoD acquisition system.

The balance of this report presents a detailed analysis of current issues affecting DoD-industry relations (Chapter 2) and a complete plan for implementing our recommendations (Chapter 3). The analysis of current issues is based on discussions held over the past 6 months with a variety of experts in the field of Government procurement. The implementation plan describes the proposed Forum's mode organization, membership, and operational mode and provides a step-by-step plan for immediate implementation.

# CHAPTER 2

# CURRENT ISSUES

Our evaluation and the resulting recommendation were based on an assessment of current issues affecting DoD-industry relations. We discussed current issues with over 50 Government contracting experts in industry, Government, and academia. (Appendix A lists the organizational affiliations of those we interviewed.) This chapter describes many of the most important issues currently dividing DoD and industry. The issues have been grouped into four major categories: DoD financial regulations, the role of the auditor, fixed-price contracts and cost sharing, and criminalization and fraud.

## DoD FINANCIAL REGULATIONS

Several recent studies have concluded that industry makes higher profits on defense contracts than on comparable commercial work and that defense contractors invest less in productivity improvements than do their commercial counterparts.[1] Stories about $400 hammers and gold-plated weapon systems have given the impression that DoD has been "throwing money" at its contractors during the defense buildup of the past few years. Detailed financial data showing profits to be higher than intended, combined with a public perception of defense industry profiteering, created an environment in which changes in DoD financial regulations were inevitable.

From the viewpoint of industry, DoD has decided it is easier to get tough with defense contractors and tighten procurement policy than to defend current financial policy or levels of profitability. As one industry observer put it, "beating up on defense contractors is the only way defense budgets and programs can be protected."

[1]The Defense Financing and Investment Review (DFAIR) found that, while defense contractor profits were only slightly higher than those earned by commercial durable goods manufacturers, they were 0.5 percent to 1 percent higher than intended by DoD policy. A subsequent Navy study charged that DFAIR understated industry's profits. According to the Navy, companies' profits on defense work were 15 percent to 20 percent higher than on commercial work. Next, the General Accounting Office (GAO) conducted a study that came closer to the Navy's conclusions, which was followed by a defense industry group study that supported DFAIR.

Some DoD observers share this view; others point to record industry profits and now-frozen defense budgets as more-than-adequate justifications for policy changes.

Whatever the merits, there is no question that changes in DoD financial policies and regulations are a major cause of the strain in relations between DoD and industry.

### Progress Payments

On 18 November 1986, DoD lowered the progress-payment rate from 80 percent to 75 percent for large businesses and from 90 percent to 80 percent for small businesses. The changes implemented Public Law (P.L.) 99-500, the continuing resolution providing DoD funding for FY87, which required that progress-payment rates be lowered at least 5 percentage points. The reduction followed an April 1985 change, ordered by Deputy Secretary Taft, which dropped the rates from 90 to 80 percent for large businesses and from 95 to 90 percent for small businesses as market interest rates declined.

### Profit Policy

The continuing resolution (P.L. 99-500) also directed DoD to institute new profit calculation procedures linking profit to financial risk. It superseded, but was generally consistent with, a DoD effort to implement changes recommended by the Defense Financing and Investment Review (DFAIR) study. The conference report accompanying the spending measure stated that the post-DFAIR profit policy proposal published by DoD in September 1986 was "generally consistent" with congressional policy objectives. Consequently, DoD accelerated the rulemaking process and reissued its proposed rule on profit policy as an interim rule, effective retroactively to 18 October 1986.

The new policy increases emphasis on facilities-capital investment and contractor risk, links working capital to profit, and aims to reduce profits by 1 percentage point. Specifically, it (1) eliminates separate profit objectives for manufacturing, R&D, and service contracts and replaces them with one objective; (2) cuts profits by 1 percentage point by eliminating profit on independent research and development (IR&D), bid and proposal (B&P), and general and administrative (G&A) expenses; (3) decreases emphasis on costs while increasing the emphasis on

risk and facilities capital employed; and (4) provides an automatic adjustment factor to compensate for changes in interest rates and the progress-payment rate.

In order to force immediate implementation of the policy changes and to meet the FY87 Gramm-Rudman-Hollings budget outlay targets, the Congress deducted $700 million from DoD's FY87 appropriations.

### Financing of Tooling and Test Equipment

Another change in financial regulations requires contractors to finance at least 50 percent of their special tooling and special test equipment costs. The change, mandated by P.L. 99-500, is generally based on a Navy policy initiative. OSD reportedly resisted the statutory requirement to implement the policy DoD-wide, preferring to wait to assess the impacts of the Navy policy. OSD's hesitation was based on concern that the change may in fact cost the Government additional money. Contractors have expressed concern that the new policy is not specific enough with respect to certain areas, including the conditions under which the Government will take title to the equipment, the amortization schedule methodology, and the method for computing the profit on the equipment.

According to the Navy, which currently requires its contractors to finance the full costs of special tooling and test equipment, the benefits of the policy include (1) an incentive for firms to be more efficient in planning and designing tooling when it is their investment and (2) a reduction in budgeting problems and Treasury outlays for production initiation, since the recovery period is spread over 8 to 10 years rather than allocated to the first production year.

### Reaction

Industry representatives voice a variety of complaints about the new profit policy. They say the drive to lower profits runs counter to DoD's announced intention to increase productivity, and will in fact stifle R&D and discourage industry investment. Many also claim that the new weighted guidelines will decrease profits by a much larger margin than predicted. These observers point to Wall Street and claim that the stock market is discounting defense company stocks by 50 percent relative to the Standard and Poor's (S&P) 400. These deep discounts, they say, show that the defense profit outlook is worse than that of other industries.

The new policy is also criticized in some quarters for lowering profits on service and research, development, test, and evaluation (RDT&E) contracts while rewarding manufacturing and other capital-intensive operations with higher profits. For example, these critics question whether profits on ship construction (which is characterized by a sizeable investment in equipment and facilities) should be higher than those on the design of electronic warfare signal processing software (which requires little or no capital investment) when we have an excess of shipyards and a shortage of software experts. Retorting, other observers point out that capital-intensive operations such as shipyards – which we need – confronted by the requirement for expensive plant, high labor costs, and a shrinking market, are going under, while services and RDT&E are flourishing.

Professional and technical service firms see themselves as particularly hard hit by the interim profit policy. Representatives of this sector of the defense industry claim that the changes will drastically reduce their profits from previous levels. Congress has recognized the professional and technical service industry's concerns and has directed DoD to adjust the final profit policy rule to assure that these firms make a "fair and reasonable profit."

Regarding progress payments, industry complains that stretched out and reduced progress payments will require companies to invest more in work in process and reduce cash flow. Since programs must be financed, and no one can find cheaper financing than the Government, the eventual outcome will be increased costs and further decreases in profit.

The progress-payment-rate reductions – together with profit reductions, and demands for contractor financing of special tooling and test equipment – are viewed by industry as efforts to gain short-term advantages from defense contractors at the expense of the long-term health of the industry. "The cumulative effect of all these disincentives," says one industry executive, "is about a 25-percent decrease, on average, in pre-tax profits." The industry people we met with were nearly unanimous in their belief that DoD has decided that the benefits of reducing short-term outlays outweigh the long-term financial risks to the defense industry.

There are mixed views of all this within DoD. Given the origin of the profit and progress-payment changes in the appropriations committees, it is hard to argue that part of the rationale for the policy changes is DoD's desire to cut costs. Most

Government observers believe that contractor profits have been very healthy in recent years and that the industry will now have to adapt to new budget realities. But where industry views the changes in financial regulations as primarily attempts to save money and score public-relations points, Government observers see public relations and budget reductions as secondary to a legitimate effort to bring profits and costs down to more reasonable levels. From the DoD point of view, the new profit policy will reduce profits only slightly for most companies, while justifiably encouraging contractors to reinvest their profits in productivity-enhancing investments for their defense business rather than in unrelated ventures. They believe that professional and technical service profits will in fact be reduced, but point out that the return on assets for services is still higher than for manufacturing. Furthermore, declines in interest rates and inflation, not just budget reductions, are thought to justify reductions in progress payments. Ninety-percent progress payments may have been appropriate during the era of 15-percent interest rates, they argue, but current economic conditions make a reduced level of support feasible.

Still, concern about the impact of changes in financial regulations has moved DoD to take a variety of actions. A study of the cumulative impacts of the changes is now under way, as is a separate assessment of the new tooling policy. In addition, the interim profit policy was revised in response to concerns expressed by R&D and professional and technical services firms. Under the new final profit rule issued in August 1987, contracting officers will have considerably more leeway in establishing profit objectives for R&D and service contracts – in effect, a separate profit policy.

## THE ROLE OF THE AUDITOR

An issue most frequently cited by both industry and DoD representatives as contributing to the adversarial relationship is the extent of duplication and the nature of contractor "surveillance," "oversight," or "review," frequently lumped together under the generic term "audit." This embraces such activities as review of contractors' purchasing systems, approval of subcontractors, insurance program reviews, cost and compensation audits, and financial reviews. The recently created contractor's operations reviews are also cited as examples of massive invasion by the Government of the contractor's domain. In an attempt to deal with the complaints voiced by industry, DoD has asked the Council of Defense Security Industrial

Associations to perform an industry survey to determine the magnitude of audit duplication.

A factor often cited in the acquisition community as responsible for the deterioration in the relationship is the growing influence and authority of the Defense Contract Audit Agency (DCAA) and the Office of Inspector General (IG) at the expense of the procurement contracting officer (PCO), the program officer, and the administrative contracting officer (ACO). The evidence set forth to support this perception includes the recent announcement that DCAA will henceforth be responsible for determining billing rates for overhead and compensation rates and for negotiating final overhead rates, thus removing from the PCO and ACO a vital part of their authority to determine contract prices, both projected and actual.

There is widespread agreement among those we interviewed that the authority of the contracting officer has been seriously eroded even though he is still the one who must sign the contract; the DoD policy of presenting one face to industry has been virtually abandoned, and the role of the ACO as a representative of the PCO has been seriously compromised.

The adversarial relationship that has developed between auditors and contracting officers is illustrated by a 28 April 1987 DCAA memorandum to its regional directors. The memorandum pertains to overhead rate determination, a responsibility formerly held by the ACO, who now, according to the memorandum, "shall not ordinarily participate." This policy has been interpreted by some in the industry and Government contracting community as an unnecessary exercise of muscle flexing on the part of the DCAA to demonstrate its newly acquired power.

The Packard Commission noted in its final report that ". . . there is an unquestioned need for broad and effective administrative oversight of defense acquisition." The National Security Industrial Association has noted that

> . . . in the interest of a strong national defense posture, the Government and the public must be convinced that the managers of defense industry are doing all in their power to operate their companies in complete honesty with a resolve to perform efficiently and to produce products which will work as intended.

In 1986, the Packard Commission found, however, that the various DoD agencies [e.g., Defense Contract Administration Service (DCAS), PCO, DCAA] lack advance planning and coordination, have ill-defined responsibilities, are unwilling

to rely on each other's work, and are reluctant to share information. Moreover, 1 yearlater, the Packard Commission, in a review[2] of how the Pentagon has implemented its recommendations, has noted that:

> Policy decisions have been made, for example, that severely undercut the role of contracting officers and the ability of program managers to direct programs successfully. Auditors have been given responsibilities outside their competence and have been afforded a separate chain of command in a way that, in effect, makes them rivals of contracting officers.... This problem results both from legislation which gives authority for audit policy to the Inspector General instead of the Under Secretary of Defense for Acquisition, and from Defense Department implementation which assigns to Defense auditors contractual responsibilities previously held by the contracting officer.
>
> .....
>
> The present and future impact of these acquisition policy decisions are a major component of the poor relations between the Department of Defense and industry, and in time could seriously weaken our defense industrial base.

These conclusions were shared by an overwhelming majority of those interviewed during this study, both Government and industry representatives.

## FIXED-PRICE CONTRACTS/COST SHARING

According to conventional contracting theory, fixed-price contracts are appropriate when stable and reasonably definitive specifications are available; production experience is present; and cost, schedule, and performance risks are low. Cost-reimbursement contracts are considered appropriate when the level of effort required is uncertain and costs cannot be accurately estimated. Also, cost-reimbursement contracts are recommended when it is expected that there will be a large number of major technical changes in a project or when unpredictable actions beyond the control of the contractor may influence contract performance.

The Federal Acquisition Regulation (FAR) (section 16.104) cites type and complexity of the requirement as a major factor to be considered in selecting contract types:

> Complex requirements, particularly those unique to the Government, usually result in greater risk assumption by the Government. This is especially true for complex research and development contracts, when performance uncertainties or the likelihood of changes makes it difficult to

[2]Letter. From David Packard. To the President. 10 Jul 1987.

> estimate performance costs in advance. As a requirement recurs or as quantity production begins, the cost risk should shift to the contractor, and a fixed-price contract should be considered.

Despite conventional wisdom and the requirements of the FAR, the Military Services have made increasing use of fixed-price R&D contracts. The Navy has been the chief proponent of this approach. In November 1985, then-Secretary Lehman signed Secretary of the Navy Instruction (SECNAVINST) 4210.6, *Acquisition Policy*, which calls for the use of fixed-price contracts in R&D. The policy says that:

> . . . a Systems Commander will not proceed to Milestone II, for a decision to proceed with full-scale engineering development (FSED), until he is satisfied that advanced development has reduced risk sufficiently to enable the contractors to commit to a fixed-price type contract that includes not-to-exceed (NTE) prices or priced production options.

Navy officials say the new policy "will do away with cost overruns on Navy contracts" and claim that fixed-price R&D contracts have saved the Navy over a billion dollars, comparing actual costs with original estimates for the T-45TS, F-14D, A-6F upgrade, and V-22 programs.

### Reaction

The policy has been controversial. The vast majority of contractor representatives we interviewed were concerned that fixed-price contracts were being used inappropriately for weapon-system development and early production – periods involving high financial risks for contractors. Industry claims that the premature use of fixed-price contracts and the requirement to give priced production options before FSED place "unconscionably high risk" on contractors.

Independent observers have criticized the practice as well. A recent study by the Center for Strategic and International Studies, titled *U.S. Defense Acquisition: A Process in Trouble*, stated:

> There is no doubt that firm fixed-price contracts can drive costs down when they function as intended. But this type of contract is not without risk or disadvantage and certainly cannot be universally applied. For instance, a firm fixed-price contract extended to the research and development phase of weapons development can be self-defeating. It is, at best, difficult to estimate the costs and time required for R&D. When the R&D risks are shifted to industry, the latter has little incentive to gamble resources on unproven technology. The fixed-price R&D contract thus tends to discourage bold research.

The report goes on to say that, "used wrongly," fixed-price contracts "can result in unanticipated future costs that negate their utility."

In its July 1987 status report on implementation of its recommendations, the Packard Commission observed:

> The apparent overall policy of increasing contractors' risks – for example, by using firm fixed-price contracts for development of systems – while at the same time reducing their ability to deal with this risk by changes in progress payments and other policies, will lead to reduced contractor investments in capital equipment and reduced Independent Research and Development. We are seeing today the same sorts of acquisition policy mistakes that characterized the enthusiasm for total package procurement in the 1960s – mistakes that produced the bitter contract claims disputes, contract restructuring, and bail-out charges of the 1970s.

Some senior OSD officials have also questioned the Navy approach. They share industry's belief that firm-fixed-price arrangements are largely "inappropriate" for high-value, high-risk R&D contracts. Like others, OSD is concerned about unanticipated future costs and diminished performance.

Another problem arises from the changed Government-industry work relationships created by fixed-price contracts. In today's competitive environment, the seller usually cannot increase his estimated cost to cover the additional risks inherent in a fixed-price R&D contract. Once under contract, the company generally wants the program office and the contracting officer to disengage so that it can accomplish the job. The contractor fears that the more it allows open discussion between Government and company engineers, the more changes "in scope" will occur, driving costs up and profits down. As a result, the seller tends to interpret many discussions as changes in scope and insists on formal direction pursuant to the *Changes* clause. Thus the flexibility of working jointly towards solving problems that exists under a cost-plus contract disappears. It is very easy for an adversarial relationship to develop.

In defense of the policy, the Navy has pointed out a number of safeguards built into the policy and has described the advantages of fixed-price development contracts. The Navy claims the following:

- The policy ensures that risk (both technical and cost) has been adequately reduced before the FSED phase.
- Contractors are motivated to ensure that pre-FSED risk-reduction efforts are genuine before committing to fixed-price FSED and production prices

with significant investments required. Once commitments on performance, cost, and schedule are made, accountability is established at the contractor's bottom line: profit or loss.

- Fixed-price contract values or ceiling prices are used in evaluating FSED and production, rather than cost estimates based on the "blank-check approach" of cost contracts. This arrangement prevents overly optimistic marketing estimates (buy-ins) from trapping the Navy in programs destined for large overruns.
- The Navy is reducing uncertainty by requiring high-level approval for any changes once a program is in FSED.
- The policy limits the buyer's obligation and permits firm obligation of funds.
- The approach equitably distributes profit and risks between contractors and DoD by rewarding productive and well-managed contractors and allowing the Navy to avoid inefficient contractors.

Another advantage, not mentioned by the Navy but noted by others (both in and out of the Government), is the political appeal of fixed-price contracts. Several contractor representatives told us of cases in which their contracting counterparts in DoD agreed that it was wrong to use a fixed-price contract but pushed the contractor to do it anyway. The reason: program managers like fixed-price contracts because they are easier to sell both in the Pentagon and on the Hill. The House Armed Services Committee recently illustrated the point when it granted the Air Force $18.2 million in advance procurement funding for five AC-130 gunships but deferred procurement itself until the Service secures a firm-fixed-price contract from the contractor.

Most contracting experts agree that it is possible to use fixed-price contracts for R&D work in certain circumstances. For example, if the desired level of contractor effort can be identified and agreed upon in advance, negotiation of a fixed-price, level-of-effort contract may be appropriate. In other cases, the company may believe that it must develop a particular item to remain competitive. If the company intends to spend the money on an IR&D project anyway, then the fixed-price contract should be acceptable. The money received under the fixed-price contract, while perhaps less than the actual cost of performance, will nevertheless reduce the contractor's expenditures.

Practices such as these may be acceptable when contractors are willing, and financially able, to assume the risk on a cost-sharing basis. But the Government must be judicious in its use of such procedures, because of its monopsonistic powers. Many observers we interviewed expressed concern about the degree to which these practices are being used. The most frequently mentioned example is the Air Force's Advanced Tactical Fighter Program. Each group of contractors competing for the production contract received a $691 million development contract in November 1986. But that amount will not nearly cover the costs of the research, personnel, and facilities that will be required to win. So each team is expected to spend between $300 million and $1 billion of its own money on the program over the next 4 years. The winners are expected to get a contract to build 750 fighters at a total cost of around $40 billion. The winners, however, are also expected to face intense pressure to keep costs and profit margins low or lose business to second-source competitors. Industry claims that, given the heavy investments, real profits might not come until the plane can be sold to foreign governments near the turn of the century.

All parties agree that the contractors have willingly participated in the program, despite the cost-sharing acquisition strategy. For major aircraft manufacturers, it is the only game in town. There are, however, major differences of opinion regarding the long-term impact. Many contractors see the new policy as abdicating the Government's responsibility to pay a "fair and reasonable" price. They question whether the added financial pressure will not eventually discourage companies from competition for new projects and weaken the industrial base. They also wonder whether the new financial obligations will lead to cuts in other promising IR&D, leaving the country vulnerable to losing its technological edge. Defenders of the cost-sharing strategy claim that the new fiscal realities of defense procurement make it necessary for industry to foot more of the bill for defense. They point out that the Pentagon is still financing considerable R&D, directly and indirectly, and that there is still reasonable potential for a fair profit.

## CRIMINALIZATION AND FRAUD

Fifty-nine of the top 100 defense contractors were under investigation for procurement fraud as of the end of 1986. By comparison, 40 of the top 100 were under investigation in 1984. A total of 222 contractors were debarred during the most recent 6-month period, compared to 193 during the preceding period. The IG

points to such data as evidence that DoD is doing a better job of rooting out fraud and safeguarding the taxpayer's dollar. The majority of acquisition professionals we interviewed, both in Government and industry, attribute the increases largely to the fact that the rules of the game have changed. There is widespread agreement that disputes which a few years ago would have been business disagreements subject to negotiation are now considered matters of fraudulent conduct subject to criminal prosecution.

Contractor representatives have been vocal in complaining about the "criminalization" of the procurement process. They feel that Government auditors and investigators are treating every questionable item as fraudulent. One contractor executive recently emphasized this point in his testimony before Congress:

> In a process as complex as defense acquisition, with so many transactions and so great a potential for honest error, we should resist the temptation to ascribe fraudulent motives to actions that can be more often and more correctly attributed to ambiguous regulations, honest mistake, or lack of adequate attention to compliance detail.

An industry association representative expressed a similar point during one of our interviews:

> In today's environment, a simple arithmetic mistake can be interpreted as a fraudulent act. The Government must recognize that a contractor's system and personnel are not and cannot be perfect at all times, and that mistakes may be made inadvertently. The contracting officer should have the authority to deal with honest mistakes by allowing the contractor to withdraw the cost or negotiating some form of consideration without feeling pressured to pursue the issue on a criminal basis.

A Government acquisition executive adds:

> In the past if there was a problem, industry and the acquisition people would straighten it out. Now, the DCAA is referring everything to the IG and the IG reports problems to Congress every 6 months. What would have been a problem solved by negotiations is now in the headlines.

### Defective Pricing

One area frequently mentioned as an example of criminalization is defective pricing. Industry and DoD contracting specialists agree that the Government has expanded its efforts to examine pricing through stricter auditing practices and a more aggressive stance on what constitutes defective cost or pricing data. Many

defective pricing cases that in previous years would have been pursued under the Truth in Negotiations Act are now being referred by DCAA to the IG for investigation for potential fraud.

The IG has listed a number of "indicators of fraud" in the pricing of Government contracts:

- Persistent defective pricing.
- Failure to correct known system deficiencies.
- Failure to update cost or pricing data with knowledge that past activity showed that prices have decreased.
- Specific knowledge, that is not disclosed, regarding significant cost issues that will reduce proposal costs. This may be reflected in revisions in the price of a major subcontractor settlement of union negotiations that result in lower increases on labor rates.
- Utilization of unqualified personnel to develop cost or pricing data used in the estimating process.
- Indications of falsification or alteration of supporting data.
- Failure to make complete disclosure of data known to responsible contractor personnel.
- Employment of people known to have previously perpetrated fraud against the Government.

Contractors point out that none of these indicators necessarily involves intent to defraud; many could result merely from a poorly functioning pricing system. This troubles the industry because, given the compressed nature of the proposal process, efforts to prepare technical, management, and cost proposals are hectic affairs. The shorter the response time and the more difficult the proposal, the more likely there will be errors in pricing – both overpricing and underpricing.

Industry people say that one particularly troublesome situation occurs when management is contemplating certain activities that could lower costs; e.g., a campaign to reduce overhead costs. Until the considerations become firm plans, it seems premature to notify the Government; after the plans have matured, the Government may deem it too late. This seems to be the issue in the Lockheed C-5B case, in which the Air Force charged Lockheed with overcharging up to $500 million on the production contract. The basis for the charge was a DCAA audit report

claiming that the company had failed to notify the Air Force of its plan to negotiate a reduction in wages with its employees.

From the perspective of the acquisition community, differences such as these should be settled as contract administration matters, not criminal matters. What has been happening, according to the vast majority of those we interviewed, is that honest differences of opinion may now be converted into alleged fraud by aggressive and increasingly powerful auditors and investigators not necessarily well versed in the complexities of defense procurement.

### Unallowable Costs, IR&D/B&P

Another major issue in the fraud or criminalization arena is the treatment of unallowable costs. From the contractor's viewpoint, the Government increasingly has attempted to establish criminal intent out of the charging of questionable indirect costs. Such costs could include unallowable costs or costs that, according to the auditor, more properly should be allocated directly to contracts.

This example of the changed environment confronting contractors was provided by a senior DoD contracts executive:

> Let's say a contractor charges a $50,000 magazine ad as a recruiting expense. The ad is in fact a mix of institutional advertising (which is unallowable) and recruiting (which is allowable). In the past an auditor would question the expense and the C.O. would look at the situation and allow say $20,000 to stand as an allowable charge for recruiting. The matter would be settled by negotiation. Today with the auditor having the final say on overhead, the whole charge is disallowed, and the matter could even be considered fraud.

One of the most frequently mentioned examples of criminalization is the "Beggs case." Former National Aeronautics and Space Administration (NASA) Administrator James Beggs had been executive vice president of General Dynamics. He and three colleagues were indicted in December 1985 on charges of defrauding the Government. The Navy suspended General Dynamics following the indictment. The company executives were charged with conspiring to shift costs incurred under a $41 million firm-fixed-price contract to build a prototype version of the Army's division air defense (DIVAD) gun to the IR&D/B&P account. The case involved a "fixed-price best efforts" contract. The contract specifications were general, and the contract left many of the specifics to the discretion of the contractor. The actions that led to the indictment involved parallel development efforts by General Dynamics

that, the company believed, were not contractually required and could therefore be properly charged to IR&D as an indirect cost. One-and-a-half years after the indictment, a Federal judge in Los Angeles granted the Government's motion to dismiss the indictment because the Justice Department conceded it had no case.

The reason this case is seen by industry as so appalling is that it demonstrates the degree to which the procurement system has been criminalized. Many in the acquisition community are asking, if a high-ranking administration official can be indicted for an accounting judgment (which was clearly a correct one), where does that leave the rest of the contracting community? Whether a cost is properly allowable, or whether it is direct or indirect, often is unclear and requires the exercise of a contractor's discretion and judgment. The current tendency for the Government to view accounting judgments and regulatory interpretations, which used to be matters for negotiation, as matters for criminal prosecution is a major cause of today's adversarial relations.

### Contractor "Self-Governance"

Not even industry's most ardent defenders claim that contractors are free of blame. The troubles of the defense industry are not merely the product of media overstatement or of overzealous investigators and auditors. Both sides agree that there have been far too many cases of industry placing profits ahead of ethical business behavior. Most frequently cited abuses include fraud in obtaining contracts, defective pricing, collusive bidding and price fixing, cost mischarging, product substitution, progress-payment fraud, bribery, subcontractor kickbacks, gratuities, and conflicts of interest.

Of these abuses, the one most frequently occurring appears to be labor mischarging. Labor costs are susceptible to mischarging because employee labor can be readily charged to any contract. The only way for the Government to assure that labor costs are charged to the correct contract is to actually observe the work of each employee to determine which contract he or she is working on and then determine from accounting records that the employee's hours are charged to the proper contract. A common problem involves transfer of labor costs from fixed-price to cost-reimbursement contracts. When a labor cost is mischarged, so is the associated overhead and G&A expense. Therefore any mischarging of labor rates costs the

Government the direct labor costs plus the applied overhead and G&A costs (which often exceed the direct costs involved).

Critics of industry point out that the contractors can hardly complain of "criminalization" if they are unwilling to police themselves to prevent abuses such as these. Some industry observers agree, arguing that contractors can no longer routinely rely on DoD auditors to identify instances where standards were not followed or where controls were weak.

Many in industry and Government believe the answer lies in contractor "self-governance" programs. The Packard Commission report stated:

> We are convinced that significant improvements in corporate self-governance can redress shortcomings in the procurement system and create a more productive working relationship between government and industry. Corporate managers must take bold and constructive steps that will ensure the integrity of their own contract performance. Systems that ensure compliance with pertinent regulations and contract requirements must be put in place so that violations do not occur. When they do occur, contractors have responsibilities not only to take immediate corrective action but also to make disclosures to DoD.[3]

The corporate self-governance programs envisioned by the Commission are ongoing, internally created and managed efforts to ensure that employees perform their duties in a legal and ethical fashion. A typical program includes adoption of a code of ethics, employee education and training, internal audits of compliance with contractual commitments and legal/regulatory requirements, and development of procedures for bringing questionable activities to management's attention. In addition, the Commission urged contractors to provide for oversight of their program by an independent audit committee consisting of nonemployee members of their board of directors.

Many defense contractors have established such programs. Thirty-seven large contractors have signed the "Defense Initiatives on Business Ethics and Conduct," setting forth six principles of business ethics and conduct to which companies agree to adhere. In addition, Deputy Secretary of Defense William Taft, in a letter to 87 top defense contractors, asked them to disclose evidence of fraud or other wrongdoing voluntarily, and in return promised that DoD would look favorably on

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[3] *A Quest for Excellence*, Final Report to the President by the President's Blue Ribbon Commission on Defense Management, p. 79.

such disclosures in deciding on the appropriate administrative action. Taft advised that voluntary disclosure, full cooperation, and complete access to records would be considered strong indications of a contractor's integrity even in the wake of disclosures of potential criminal liability. He noted that the extent of a voluntary disclosure would be made known to the Justice Department for use in deciding what actions would be necessary. Justice has formally endorsed the voluntary disclosure policy. It also has provided general guidance on the steps it will take in such cases, saying "... contractors that make serious and responsible efforts to comply with the law and disclose misconduct should not be discouraged from these practices by inflexible prosecution policies."

In July 1987 the Packard Commission held a meeting to discuss the progress made over the past year in implementing the Commission's 1986 recommendations. In a letter to President Reagan, Mr. Packard said "... significant efforts have been made by industry and the Defense Department in the fields of industry self-governance and voluntary disclosure." Despite this upbeat assessment, our research has turned up a number of contentious issues associated with implementation of the contractor self-governance recommendations.

### *Self-Governance Clauses*

In March 1987, the Defense Acquisition Regulatory (DAR) Council published a proposed rule aimed at implementing the Packard Commission's self-governance recommendations. The rule would require defense contractors to establish written codes of business ethics and to set up mechanisms – such as hotlines – through which employees could report improper business conduct. It would also require DoD contractors to establish programs for disciplining employee misconduct and reporting improper actions to the Government. A related proposal, published by the DAR Council in November 1986, calls for a new clause requiring contractors to set up employee awareness programs. It requires that all awareness programs include elements such as employee orientations and a posted "DoD Inspector General Hotline."

The defense industry opposes these regulatory requirements. The Council of Defense Security Industrial Associations urged DoD to consider the "very substantial" commitment that industry has made to voluntary self-governance programs and recommended that company-sponsored programs be given time to

work before a mandated Federal program is instituted. Industry argues that contractors need the flexibility to develop programs that are best suited to their specific circumstances. As a result of this industry opposition, both proposals have been put on hold. The OSD's Office of General Counsel is scheduled to meet with representatives of the Packard Commission to discuss the regulatory proposals and industry concerns in an attempt to fashion an approach compatible with the Commission's recommendations.

### *Treatment of Disclosures*

As mentioned above, Deputy Secretary Taft has sent letters to the major defense contractors asking them to disclose evidence of possible fraud voluntarily. The request has been very controversial and has raised a number of industry concerns. In the view of some contractors, the voluntary disclosure program is an effort by DoD and the Department of Justice to induce contractors and their employees to disclose a variety of problems without any protection from administrative, civil, or criminal sanctions. Industry complains that, although the Taft letter indicates that DoD will "look favorably" on disclosures in deciding on the appropriate punishment, DoD recommendations are not binding on Justice. The American Bar Association notes that the Government has waived none of its rights to prosecute contractors and then debar them on the basis of any resulting convictions.

Other concerns have been raised because the information subject to disclosure extends beyond the possible criminal conduct discovered by the company. Critics warn that the IG will not accept contractor disclosures at face value, but will verify the information with their own agents. Once these agents are investigating a company, they may look for anything and are free to examine the entire company to determine whether everything has been disclosed. The results of internal audits are frequently requested by inspectors, auditors, and investigators, and the courts have often sustained their requests.

Some in the legal community are claiming contractors would be better off investigating and correcting possible procurement fraud or irregularities on their own instead of participating in the DoD/Justice voluntary disclosure program. They say there is nothing in the regulations to prevent a company from making a "privileged inquiry" into its own problems, correcting the problems, and reimbursing

the Government for any loss. This approach, some argue, would allow a company to demonstrate its current responsibility and, by its forthright conduct, preserve its right to continue to receive Government contracts. This independent approach would maintain a company's integrity without exposing employees and officers to criminal investigation. Proponents say it would also avoid the problems created by having corporate personnel act as investigators on behalf of the Government.

There is concern about the self-governance/disclosure program inside the Government as well. Several members of Congress have been quoted publicly as saying the approach is "...analogous to the fox guarding the chicken coop." Secretary Weinberger, while supporting the self-governance effort, has warned:

> A significant error will be made, however, if we think that the whole problem of self-governance is, at root, a public relations challenge. Far from it. The key to restoring public confidence is not simply the promise of better conduct. It is action, taken by business and DoD, to correct abuses and to implement procedures that prevent their recurrence. In short, it is better conduct.[4]

Others in DoD share this concern. There is much skepticism about self-governance in the contracting community. It will take time for many of the uncertainties to disappear. The Deputy Director of DCAA recently wrote:

> Although the prospects of reducing the need for Government oversight must be attractive to contractors (and to the taxpayers who have to pay for the oversight), it is not realistic to expect it to occur overnight by proclamation. A lot of conscientious hard work is going to be required by everybody involved to make it happen. Until recently, few contractors have made concerted attempts to develop well-structured systems for assuring compliance with contract laws and regulations. Now, many more are beginning the effort. Before those systems may be relied on the significant levels of confidence, their operation must be observed, tested, and revised as necessary.[5]

The problem is that the very lack of trust between industry and DoD making self-governance programs necessary also makes their success unlikely. Just as the Government investigators would like to see whether systems are working before they trust them enough to reduce oversight, the contractors would like the freedom to make their self-governance programs work without Government "interference."

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[4]Weinberger speech to the First Annual Best Practices Conference, Washington, D.C., 30 Oct 1986.

[5]"Contractor Self-Governance: A Contract Auditor's Perspective," *Contract Management* magazine, Apr 1987.

Similarly, the Government would like contractors to come forward with problems as proof that the systems are effective; yet contractors are reluctant to come forward because of fears of unfair treatment. Industry and Government will have to communicate openly and work closely together if these impasses are to be resolved and self-governance programs are to be successful.

# CHAPTER 3

# IMPLEMENTATION PLAN

To achieve improved communication between DoD and industry, we have recommended establishing a DoD-Industry Forum under the aegis of the National Academy of Public Administration (the National Academy). This chapter contains a plan for implementing the proposed Forum. It discusses the details of the Forum's structure and operations and describes the steps required to establish the Forum.

## DETAILS OF THE FORUM

### Sponsorship

The Forum would be sponsored by the National Academy. The National Academy is chartered by Congress to provide independent advice and counsel on the organization, processes, and programs of Government. In 1984, President Reagan signed the National Academy's congressional charter, the first such charter since President Lincoln signed the charter for the National Academy of Sciences in 1863. In his letter to the National Academy, President Reagan said: "It is my hope and conviction that future administrations and Congress will profit from the research and counsel provided by the National Academy to increase the effectiveness of Government." Appendix B contains a copy of the National Academy's charter (P.L. 98-257).

As the sponsor of the DoD-Industry Forum, the National Academy would host the meetings. It would convene quarterly meetings, develop agendas, and facilitate the exchange of views on important issues in DoD-industry relations. Academy members would be available to serve as advisors to the Forum on matters of particular interest.

### Forum Organization and Membership

As mentioned on page 1-6, the Forum would be chaired by the Under Secretary of Defense for Acquisition. The DoD membership would be comprised of the Assistant Secretary of Defense (Production and Logistics) and the Policy Initiatives

Committee of the Defense Acquisition Board [senior procurement executives from each of the Military Departments, plus the Deputy Assistant Secretary of Defense (Procurement)]. Additional DoD executives would be invited depending on the issues to be discussed.

Industry members would be selected by the National Academy, with consultation and advice from industry associations and DoD. Twelve CEOs would serve as core members of the Forum. Supplemental industry attendance would be tailored to the particular issue being discussed. Industry members would be chosen for their ability to provide expert opinions. They would be chosen because of their personal backgrounds in defense industry management and not on the basis of company affiliation. Industry members would serve revolving 3-year terms. An industry representative would serve as vice-chairman of the Forum.

### Forum Operations

The Forum would conduct a 1-day meeting four times a year at the National Academy headquarters in Washington, D.C. The National Academy's Executive Secretariat would undertake meeting arrangements and would provide administrative support and background materials to Forum members in preparation for the meetings. The Executive Secretary of the National Academy would formulate the agenda for each meeting, in consultation with appointed Forum leaders. Both the chairman and vice-chairman of the Forum would approve the agenda in advance.

Meeting agendas would be narrowly focused. A narrow focus is critical, since the objective is to hold in-depth discussions on three or four selected issues rather than superficial discussions on the full range of issues. The Forum charter should provide guidance on the organization's operating principles. The charter should prohibit the discussion of company-specific problems. Since the value of the Forum will depend, in part, on developing mutual trust on the part of the participants, the charter should also rule out the use of substitute attendees. A National Academy member would attend each meeting of the Forum to participate in the discussions and make available the National Academy's expertise in public administration.

Issues of particular importance could be addressed by joint DoD-industry working groups. Working groups would be temporary. They would be formed on an issue-by-issue basis in order to answer questions and resolve uncertainties raised by Forum members. Each working group would be comprised of four to eight senior

managers, half from industry and half from DoD. A member of the Forum would chair each working group. Working groups would meet as often as needed to accomplish the task assigned. Generally they should complete their work in time for the working group chairman to present their findings at the next quarterly meeting of the DoD-Industry Forum.

On rare occasions, it might be worthwhile to have an outside speaker address the Forum. For example, senior officials from other Departments (e.g., Justice, State) might be invited to speak on topics relevant to national defense management. However, every effort should be made to limit the time devoted to outside speakers and working-group presentations. It is important that Forum members spend as much time as possible in a frank exchange of views on the important issues of the day. Meeting time spent listening to briefings and reading reports should be kept to a minimum.

From time to time it might be helpful to have a neutral, in-depth assessment of issues facing the Forum. Under these circumstances the Forum could request the National Academy to form a project panel composed of National Academy members and other invited experts from inside and outside Government. Studies recently conducted by National Academy panels at the behest of the Government include:

- America's Unelected Government: Improving the Presidential Appointments Process – a study to improve the recruitment, training, and working environment of top Presidential appointees, based on an evaluation of practices from 1960 to the present.
- Revitalizing Federal Management – sponsored by 18 Federal agencies: an examination of ways to improve Government effectiveness by placing greater authority with Federal managers.
- Organization for the Operational Space Shuttle – sponsored by NASA: an examination of organization and management options for space-shuttle operations.

### Operational Constraints

To function effectively, the Forum must operate in an atmosphere of candid and open exchange of views on sensitive matters. The Forum must be free to gather information, explore options, and discuss and evaluate alternatives in an unpressured environment.

Questions have been raised about whether the proposed Forum, established under the auspices of the National Academy, would be subject to the Federal Advisory Committee Act (FACA), P.L. 92-463. LMI subcontracted for a legal analysis to determine whether or not the National Academy-sponsored Forum would be subject to the Act.

The legal analysis concluded that FACA would not apply to the proposed Forum. First, the National Academy is not an "agency" under FACA. Second, the Forum would not be an advisory committee under that Act, because the Forum would not be created by statute, nor would it be "established or utilized" by DoD within the meaning of FACA. The Forum would be established only by the National Academy, which is not itself subject to FACA. The courts have limited the application of FACA to situations where agencies seek advice from groups on impending agency action, such as proposed regulations. Propose General Services Administration (GSA) regulations confirm the limitation of FACA to instances where an agency is "seeking" the "advice" of a group, which the agency ". . . adopts . . . as a preferred source from which to obtain advice or recommendations on a specific issue or policy. . . ."

Accordingly, the meetings of the proposed Forum would not be open to the public under FACA, the meetings would not be required to be announced in the Federal Register, and the Forum's records and reports would not be subject to requests for public inspection and copying under FACA.

Aside from FACA considerations, the analysis concluded that the National Academy would not be subject to a direct challenge under the Freedom of Information Act, 5 U.S.C. 552 (1982), or the Sunshine in Government Act, 5 U.S.C. 552b (1982).

## NEXT STEPS

If the recommendations in this report are adopted, the Forum can be established quickly. First, OSD must secure agreement from the Military Departments regarding participation and membership. We have suggested that the DoD component of the Forum be comprised of the members of the Policy Initiatives Committee of the Defense Acquisition Board. Participation in the DoD-Industry Forum is a logical means for the committee's members to acquire input from the

contractor community. Forum membership could be assigned as an added responsibility to existing committee members.

After OSD and the Military Departments agree on participation in the Forum, OSD can contract with the National Academy to formally establish the Forum. We have worked closely with the National Academy in developing this proposal. The National Academy's management is familiar with both the details of the Forum concept and the specific issues that must be addressed. Once under contract, the National Academy can move quickly to select industry participants (using advice from industry associations and DoD), establish the Forum's charter and operating guidelines, and set the agenda for the first meeting. The issues discussed in this report provide a list of potential agenda items. Several issues, or families of issues, will be extremely difficult to resolve. None will be easy, but we suggest addressing the less controversial ones first to give people a chance to become comfortable with the operation of the Forum before delving into the most contentious issues. One possible lineup is as follows:

| | |
|---|---|
| First Meeting: | Organizational Details<br>Fixed-Price Development Contracts |
| Second Meeting: | Audit and Oversight Issues |
| Third Meeting: | Financial Regulations |
| Fourth Meeting: | Fraud, Criminalization, and Self-Governance |

After an agenda is established, the National Academy can schedule the first meeting and begin making meeting arrangements and preparing background materials. We believe the first DoD-Industry Forum meeting can be held within 6 months of DoD's decision to participate.

Since the Forum concept is new, it is important that its operations remain somewhat flexible so that it will have a chance to evolve over time. Likewise, at the end of the first year of operations, the participants should assess the utility of the Forum and determine whether it is worthwhile to continue.

# APPENDIX A

# LIST OF ORGANIZATIONS INTERVIEWED

## LIST OF ORGANIZATIONS INTERVIEWED

Over 50 experts on Government contracting were interviewed during the course of this study. In order to ensure candid responses, the interviews were conducted on a nonattribution basis. The organizational affiliations of those interviewed are shown below:

Aerospace Industries Association

American Electronics Association

The Analytic Sciences Corporation

The Boeing Company

Congressional Budget Office

Contract Services Association

Defense Contract Administration Service

Defense Logistics Agency

Electronics Industries Association

George Washington University

Harbridge House Corporation

Machinery and Allied Products Institute

Martin Marietta Corporation

National Academy of Public Administration

National Academy of Sciences

National Security Industrial Association

Office of the Secretary of Defense

Peat, Marwick, Main

Procurement Roundtable

Professional Services Council

Unisys Corporation

United States Air Force

United States Army

United States Navy

# APPENDIX B

# FEDERAL CHARTER FOR THE NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

# FEDERAL CHARTER FOR THE NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

98TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
1st Session } { No. 98-491

## NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

NOVEMBER 7, 1983.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. SAM B. HALL, JR., from the Committee on the Judiciary, submitted the following

## REPORT

[To accompany H.R. 3249]

[Including cost estimate of the Congressional Budget Office]

The Committee on the Judiciary, to whom was referred the bill (H.R. 3249), to charter the National Academy of Public Administration, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Page 5, line 14: Strike "( )" and insert in lieu thereof "(61)".

### PURPOSE

The bill H.R. 3249, as amended, would grant a Federal charter to the organization known as the National Academy of Public Administration.

### STATEMENT

The National Academy of Public Administration is an independent, nonprofit corporation, dedicated "to provide a recognized and trusted source within the public administration community for advice, counsel and assistance to public administrators." It is an elected association of nearly 300 public administrators, academic figures, business and labor leaders. Membership in the National Academy of Public Administration is nondiscriminatory, but members are selected based on their contributions to the field of public administration and their dedication to improved government operations.

The Subcommittee on Administrative Law and Governmental Relations received testimony on H.R. 3249 at a hearing on October 26, 1983. Testimony demonstrated that the organization has served Congress and the executive branch since its inception in 1967. A great deal of the academy's effort has been carried out in response to individual

31-006 O

agency requests for help in solving problems associated with particular programs. In addition, the National Academy of Public Administration has aided Congress in shaping several major pieces of legislation. The value of the academy is not only derived from the expertise of its members but also from its nonpartisan, independent status. The organization is dedicated to, and has contributed to, making government work better.

The purpose of this legislation is merely to recognize an existing State-chartered organization. It does not expand any corporate rights or relieve any corporate responsibilities established by State charter. Moreover, this legislation specifically requires compliance with State laws governing the election of corporate officers and the responsibilities of the board of directors for the corporation. It also specifically requires compliance with State laws governing service of process.

In order to assure responsible and appropriate conduct on the part of the corporation, the legislation prohibits certain corporate acts and establishes certain requirements for the corporation. The legislation prohibits the loan or transfer of corporate assets to officers, members, or other persons (except for expenses), lobbying or other political activity by the corporation or the issuance of stock or the payment of dividends. The legislation further prohibits the corporation from claiming congressional approval or Federal Government authority for any of its activities. The legislation requires the corporation to keep certain records, to perform an annual audit and to report to Congress annually. Should the corporation engage in any prohibited activity or fail to perform any of the requirements established by this legislation, or if the corporation fails to maintain its tax exempt status, the Federal charter granted by this legislation will expire automatically as a matter of law.

The committee favorably recommends H.R. 3249, as amended, to the House for its consideration.

Statements under clause 2(l)(3)(A), clause 2(l)(3)(B), clause 2(l)(2)(B), clause 2(l)(3)(D), clause 2(l)(4), and clause 2(l)(3)(C) of rule XI and clause 7(a)(1) of rule XIII of the House of Representatives:

COMMITTEE VOTE

(Rule XI, Clause 2(l)(2)(B))

On November 1, 1983, the full Committee on the Judiciary approved the bill H.R. 3249 by voice vote.

COST

(Rule XIII(7)(A)(1))

The bill merely provides for granting of a charter to a nonprofit corporation and its enactment would result in no added cost to the government other than to examine the annual audit required by law.

## OVERSIGHT STATEMENT

(Rule XI, Clause 2(l)(3)(A))

The Subcommittee on Administrative Law and Governmental Relations of this committee exercises the committee's oversight responsibilities relating to the chartering of private nonprofit corporations in accordance with rule VI(b) of the Rules of the Committee on the Judiciary. The favorable consideration of this bill was recommended by the subcommittee and the committee has determined that the legislation should be enacted as set forth in this bill.

## BUDGET STATEMENT

(Rule XI, Clause 2(l)(3)(B))

As had been indicated in the committee statement as to cost made pursuant to rule XIII(7)(a)(1), the bill merely provides for the incorporation of a private nonprofit corporation. This bill does not involve new budget authority nor does it require new or increased tax expenditures as contemplated by clause 2(l)(3)(B) of rule XI.

## INFLATIONARY IMPACT

(Rule XI(2)(l)(4))

In compliance with clause 2(l)(4) of House Rule XI it is stated that this legislation will have no inflationary impact on prices and costs in the operation of the national economy.

## ESTIMATE OF THE CONGRESSIONAL BUDGET OFFICE

The following estimate was received from the Director of the Budget Office:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
*Washington, D.C., November 4, 1983.*

Hon. PETER W. RODINO, Jr.,
*Chairman, Committee on the Judiciary, U.S. House of Representatives, Washington, D.C.*

DEAR MR. CHAIRMAN: Pursuant to section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has reviewed H.R. 3249, a bill to charter the National Academy of Public Administration, as ordered reported by the House Committee on the Judiciary, November 1, 1983.

The bill recognizes and grants a charter to the National Academy of Public Administration. The academy is required to examine and report on governmental matters when requested by the Federal Government, with the cost of such studies to be paid by the Government.

The CBO estimates that no costs will be incurred by Federal, State or local governments as a result of enactment of this bill.

Should the committee so desire, we would be pleased to provide further details on this estimate.

RUDOLPH G. PENNER.

CHANGES IN EXISTING LAW MADE BY THE BILL AS REPORTED

In compliance with paragraph 2 of clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

* * * * * * *

Section 1 of the Act entitled "An Act to provide for an audit of accounts of private corporations established under Federal law", approved August 30, 1964, as amended (Public Law 88-504, § 1, August 30, 1964, 78 Stat. 635; 36 U.S.C. 1101)

* * * * * * *

The term "private corporations established under Federal law" as used in this Act means the following organizations:

* * * * * * *

*(61) National Academy of Public Administration*

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19. ABSTRACT *(Continue on reverse if necessary and identify by block number)*

DoD-industry relations are presently troubled. Tensions between DoD and its contractors, inherent in the political and regulatory environment in which they operate, have been exacerbated by the current focus on procurement problems and by DoD's dual role as both customer and regulator. The major issues fall into four categories: financial regulations; the role of the auditor; fixed-price contracts and cost sharing; and fraud, criminalization, and self-governance. The report discusses the views of DoD and industry on these issues.

If the strains in the relationship are to be controlled, communication and understanding must be promoted. But DoD has no established mechanism for maintaining a structured dialog with the defense industry on the important issues of the day. To achieve this end, the report recommends creating a DoD-Industry Forum under the auspices of the National Academy of Public Administration (NAPA), which is congressionally chartered for the purpose of improving the efficiency of Government management.

As the Forum's sponsor, NAPA would bring senior executives from DoD and industry together to discuss defense acquisition problems and explore solutions. Chaired by the Under Secretary of Defense for Acquisition, the Forum would include the Assistant Secretary of Defense (Production and Logistics), the Policy Initiatives Committee of the Defense Acquisition Board, and 12 industry CEOs selected by NAPA with advice from industry

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19. ABSTRACT (Continued)

associations and DoD. The Forum would meet quarterly, with a focused agenda. Discussions of company-specific problems would be prohibited. Complex issues of particular importance would be addressed in detail by joint DoD-industry working groups. The report concludes with a plan for implementing the Forum concept.

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